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VIEWS FROM CAMELBACK MOUNTAIN

The Coronavirus Panic

Financial markets around the world have been in panic mode for the past week. Markets declined Thursday and Friday of last week and the declines continued Monday, Tuesday, and Wednesday of this week. As of early Thursday, February 27, the market was set to open with additional declines. This has been a very sharp decline from the all-time highs that financial markets hit just last week. As of the close on Wednesday, February 26, the Standard & Poor's 500 was down 8.2% and the Dow Jones Industrial Average was down 8.8%. With today's declines, both of these indices will likely be down more than 10% in six days. In the meantime, the yield on a 10-Year Treasury is at a new all-time low of 1.27% and oil prices have declined dramatically. The market is in panic mode and has priced in a very high probability of an economic recession both here and around the world.

Of course, we can't tell how far the Coronavirus will spread and what its impact on global commerce will be. Neither can anyone else even hope to predict what lies ahead for the Coronavirus. It is instructive to review how things stood a little more than a week ago and what the likely outcomes are.

Last week, when the markets hit their highs investors were feeling pretty good about global growth and international trade. Investors were optimistic that President Trump's trade wars with China and those with Mexico and Canada had been put to rest, at least for the near term. China was reducing tariffs and there were hopes that durable goods orders might pick up as companies began to feel more confident to make investments in light of the resolution of significant trade concerns. This morning, we found that the second estimate for 4^{th} quarter GDP came in at a 2.1% growth rate and that durable goods orders did, in fact, rise nicely.

That was then, but now companies are beginning to announce uncertainty about 1^{st} quarter earnings and perhaps 2^{nd} quarter earnings in light of the impact of the Coronavirus. In the case of Microsoft, their earnings shortfall is expected to be entirely driven by supply chain issues impacting the manufacture and export of computer hardware, largely from China. Many companies will be impacted, but we are still hopeful that most of the impact will be relatively short-term delays rather than purchases simply being canceled. Obviously, almost no one bought an iPhone yesterday in China. All of those folks that had previously planned to buy an iPhone in China yesterday will probably buy one eventually and thus, most of the sales are likely to be delayed, not canceled.

We understand that investments in cruise ship lines, airlines, travel and entertainment related businesses will likely be impacted, some long-term. Manufacturers with supply chains tied to China will be impacted and this is the reason that technology and electronics companies have been hard hit. Transportation companies have also come under pressure. None of us would travel to China or anywhere else in Southeast Asia anytime soon. We think that the summer Olympics in Tokyo may be canceled, but if they aren't, tickets should be pretty easy to come by.

With the ongoing development in computer trading and algorithmic artificial intelligence trading, markets now price in new developments in seconds or minutes rather than in weeks or months. The markets are now down slightly more than 10%. A market correction is defined as a 10% decline from a previous high. Corrections involving declines of 10% - 15% occur, on average, every 12-18 months but do not occur on any regular schedule or timeline. We expect that the Coronavirus panic is going to turn out to be a normal correction. If that's true, the vast majority of the market damage is behind us already and selling stocks now is not advisable. If on the other hand, the Coronavirus spreads so dramatically that it triggers a worldwide recession, the markets might well suffer a 20% - 30% decline from their previous highs. Even if this were to occur, one-third or half of the potential damage has probably already occurred.

For this reason, we are not suggesting any portfolio changes at this time. It's a little too early for most of our clients to begin taking advantage of the decline by selecting great companies that have been hard hit. As we learn more about the likely future developments with the virus, we may well want to take advantage of some of these opportunities.

So far, about 82,500 cases have been confirmed worldwide, mostly in China. About 2,800 deaths have occurred. There are large outbreaks in Korea, Italy, Iran and elsewhere. So far, there are 15 cases in the U.S., not including folks evacuated from the Diamond Princess cruise ship.

To give you some perspective, the CDC estimates that 61,000 Americans died from the flu in the 2017-2018 season and another 34,000 in the 2018-2019 season. Against that backdrop, fewer than half of Americans even bother with flu shots. Going forward, people worldwide are likely to change behavior using hand sanitizers, avoiding shaking hands, staying home when sick, and perhaps even using surgical masks. This is a scary time because we can't tell for sure how things will develop, but we believe the market has already priced in a very significant impact.

As we learn more and particularly if we change our opinion on market conditions, we will let you know immediately.

Warmest Regards,

Harry Papp
Managing Partner
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